

## 3.4 Economic integration

### Learning Outcomes

- Distinguish between bilateral and multilateral (WTO) trade agreements.
- Explain that preferential trade agreements give preferential access to certain products from certain countries by reducing or eliminating tariffs, or by other agreements relating to trade.
- Distinguish between a free trade area, a customs union, and a common market.
- Explain that economic integration will increase competition among producers within the trading bloc.
- Compare and contrast the different types of trading blocs.
- Explain that a monetary union is a common market, with a common currency and a common central bank.
- Discuss the possible advantages and disadvantages of a monetary union for its members.
- Explain the concepts of trade creation and trade diversion in a customs union. (HL)
- Explain that different forms of economic integration allow member countries to gain from economies of scale. (HL)

#### Glossary

**unification** joining together

**explicit** expressed in a clear and direct way

#### Subject vocabulary

**fiscal policy** government policy designed to achieve macroeconomic objectives through government expenditure and taxation

**monetary policy** the control of the supply of money by the central bank to affect the economy (e.g. changing interest rates)

**trade barriers** restrictions put in place by government on international trade in order to protect domestic jobs and industries. Examples include subsidies and tariffs.

**quotas** a physical limit placed on the number of goods that can be traded or produced

**tariffs** a tax placed on imported goods and services

### What is economic integration?

Economic integration occurs when countries agree to remove barriers to the movement of goods and services, barriers to the movement of capital, and barriers to the movement of labour. The final stage of economic integration is the **unification** of the **fiscal policy** and **monetary policy** of the participating countries.

### Distinguish between bilateral and multilateral trade agreements

An agreement on trade between two countries, usually concerning the removal of **trade barriers** such as of **quotas** and **tariffs**, is a bilateral agreement. A multilateral trade agreement is an agreement on trade involving more than two countries.

### What is a trading bloc?

A trading bloc consists of a number of countries that come together to form an agreement to remove trade barriers that exist between them.

### What is a preferential trade agreement (PTA)?

A preferential trade agreement is an agreement between two or more countries to reduce the barriers to trade on only certain goods and services. Tariffs could be reduced on certain imported goods but only on the named imported goods and only on those from the countries that have reached an agreement. The tariff is not reduced on these goods imported from all countries. These are called tariff preferences. A PTA is the first step towards economic integration.

### Distinguish between a free trade area, a customs union, and a common market

A free trade area (FTA) is an extension of a preferential trade area. It is an agreement that allows free trade between participating countries. It can be a bilateral or multilateral agreement. Quotas and tariffs on all traded goods are removed. Each country in the FTA is able to come to their own agreement on trade with other countries outside of the FTA.

A customs union is a group of two or more countries that have agreed to remove trade barriers. Unlike an FTA a customs union puts up common barriers to trade, such as tariffs or quotas on some imported goods and services from countries that are not in the customs union. When the customs union has agreed a common tariff or quota it means that all participating countries must impose the same tariff or quota on imported goods. Goods move freely within the customs union but capital and labour do not.

A common market is a group of two or more countries that agree to remove barriers to trade and agree to put up common trade barriers against imported goods from non-member countries. Unlike a customs union a common market allows freedom of movement of capital and labour throughout the member countries. This is a further step towards full economic integration.

**Model sentence:** Customs unions and common markets, unlike free trade areas, erect common barriers to trade.

**Model sentence:** Common markets, unlike customs unions, allow the freedom of movement of capital and labour between member countries.

## What are monetary unions?

A monetary union is another step toward full integration. Monetary unions have the same form of economic integration as common markets. The difference between a common market and a monetary union is that, in a monetary union, member countries agree to share the same currency. Member countries give up their own currency for the shared currency. The power to set the supply of the currency and interest rates are transferred from the central bank of each member country to a single central bank. The countries can no longer control their own monetary policy. The individual states of the USA do not control the money supply, or interest rates, these are set by the Federal Reserve. In 1999 some member countries of the European Union joined the **Euro-zone**. The countries gave up their currencies for the euro. Monetary policy in the Euro-zone is set by the European Central Bank. The countries in the Euro-zone still have tax-raising powers and control government expenditure. Therefore the Euro-zone is not fully integrated because fiscal policy is still determined by the governments of the individual countries in the Euro-zone.

## Discuss the advantages and disadvantages of economic integration

Many of the advantages and disadvantages of economic integration come from the removal of barriers to trade and the promotion of free trade. These are discussed in detail in Section 3.1.

In summary the advantages gained by the removal of tariff and quotas are as follows.

The removal of tariffs and quotas reduces the price of imports thereby increasing the **purchasing power of nominal income**. **Real income** increases and consumers are able to satisfy more wants with their scarce income. As price falls consumer surplus increases and, therefore, **consumer welfare** increases. Firms that import raw materials benefit from lower costs of production, therefore, average costs fall and supply increases. Firms become more price competitive and demand for their exports increases. Consumers can also enjoy a greater choice and variety of goods and services, which also increases consumer welfare.

Free trade allows firms to export goods to a much larger market. Firms can gain cost advantages from **economies of scale** as output increases, thereby further reducing average costs. Growth in output of exporting industries increases investment in the industries. This brings benefits to the economy as a whole such as **economic growth**, greater levels of employment, and a reduction in the **current account deficit**.

Free trade allows for a more efficient allocation of **resources**. Industries that are no longer protected cannot hide inefficiencies behind tariffs and quotas. Goods and services are produced in countries that have a comparative advantage in their production. Fewer of the world's scarce **factors of production** are used to produce goods, therefore more goods can be produced with a given quantity and quality of factors.

Foreign direct investment may increase as firms outside of the trading bloc invest within the bloc in order to benefit from the large single market.

In summary the disadvantages of free trade are as follows.

The less efficient domestic firms will not be able to compete against lower priced imports. Firms shut down and unemployment rises.

Tax revenue from tariffs will no longer be available to governments, reducing the amount they have to spend on **public goods**, **merit goods**, and **infrastructure**.

When a country has few cost advantages, and its exporting industries are relatively inefficient, the demand for imports will be greater than the demand for its exports, leading to a persistent current account deficit. (The consequences of a high current account deficit are discussed in detail on pages 232–34.)

Countries no longer able to use tariffs and quotas to protect domestic industries may use other less **explicit** methods. Some countries put up barriers to trade by making health and safety standards, environmental standards, and quality standards very difficult to meet.

## Subject vocabulary

**Euro-zone** those European Union countries which have adopted the euro

**purchasing power** a measure of how many goods and services a given amount of money can buy

**nominal income** the numerical value of income which has not been adjusted to take into account the effect inflation has on the purchasing power of income

**real income** income after taking into account the effects of inflation on purchasing power

**consumer welfare** a measure of the benefit obtained from the consumption of goods

**economies of scale** the fall in average cost in the long run brought about by an increase in the size of a firm's operation

**economic growth** an increase in real GDP

**current account deficit** occurs when the amount of money flowing out of a country from the trade in goods and services, investment income, and transfers is greater than the amount flowing in

**resources** the inputs into the production process, the factors of production

**factors of production** the inputs into the production process (land, labour, capital and entrepreneurship)

**public goods** a good that is non-excludable and non-rivalrous. Once provided it is not possible to stop people benefitting from the consumption of it and therefore people free ride – they do not pay. The good will not be supplied left to the free market because no firm would be able to make a profit. Also, consumption of the good by one person does not diminish the amount available for others to consume.

**merit goods** goods that the government believes will be under consumed left to the free market. Consumption of a merit good may generate positive externalities therefore the social benefit of consumption is greater than the private benefit.

**infrastructure** the physical systems of a country that includes transport and communication networks and sewage, water, and energy supply systems

## Discuss the advantages and disadvantages of monetary union

There are many advantages and disadvantages of monetary union. The main advantages are explained below:

### Subject vocabulary

**foreign exchange market** a decentralized global market for the buying and selling of currencies

**average total cost** is equal to total cost divided by quantity of output

**exchange rate** the price of a country's currency in terms of another currency

**rates of inflation** the rate at which a weighted average price of a basket of goods and services is rising

**economic cycle** the fluctuations in economic activity over time. There are four stages of the business cycle: (1) recession, when economic activity slows down; (2) trough, when the recession is at its deepest; (3) recovery, when the economy begins to grow; and (4) peak/boom, when economic activity is high.

**recession** two consecutive quarters of negative economic growth

**aggregate demand** the total demand for goods and services in the economy at a given price level in a given period of time

**rate of economic growth** the percentage increase in a country's output in a given period of time

### Explain how the removal of transaction costs reduces business costs

When trade occurs between countries currencies must be exchanged on the **foreign exchange market**.

Resources are used to do this. When countries within a monetary union trade they share one currency.

Resources used to exchange currencies can be used for other purposes. So monetary union reduces business costs and frees up resources because currencies no longer need to be exchanged.

### Explain how price transparency reduces business costs and improves efficiency

A single currency makes it a lot easier for buyers to see and compare the price of goods across many countries.

Prices are more transparent, there is no need to calculate price in one currency from the many different exchange rates. Buyers have a much better knowledge about prices in the market. Over time firms can reduce their costs of production, and produce more efficiently, because they know where they can buy goods at the lowest price. In

monetary unions, inefficient firms will not survive because governments can no longer devalue the currency to reduce the price of their exports. The firms either become more efficient or go out of business. The most efficient firms – able to produce at low **average total cost** and sell at low prices – will survive and grow.

### Explain how the removal of exchange rate fluctuations increases investment

Fluctuations in the **exchange rate** change the earnings on foreign assets, because the returns on foreign investments are paid in the foreign currency and will need to be exchanged to the home currency of the owner of the assets. This increases the uncertainty and risk of cross-border investments including foreign direct investment. For example, when an investor in the UK invests in assets in Australia the British pound is exchanged for Australian dollars in order to buy the assets. The returns on the investment are paid in Australian dollars and must then be exchanged for British pounds. If the British pound increases in value against the Australian dollar it reduces the return paid on the investment. Therefore exchange rate fluctuations increase the risk and uncertainty of cross-border investment, leading to a fall in the level of investment. Cross-border investment within a monetary union is less risky because there is no exchange rate.

### Explain how monetary union reduces currency speculation

Currency speculation occurs when investors buy a foreign currency in the hope of selling the currency at a higher price in the future. Currency speculation causes fluctuations in the exchange rate making the exchange rate unstable. This reduces confidence in the economy of the country and leads to a fall in investment. A single currency of a large monetary union, such as the Euro-zone, is less likely to come under attack by speculators and therefore the exchange rate will be more stable. A small country joining a monetary union might see this as a big advantage.

### Explain how membership of a monetary union might reduce inflation

Relatively high **rates of inflation** reduce international competitiveness. A country can devalue its currency in order to make their exports more price competitive, offsetting the increase in price due to inflation. When a country joins a monetary union it loses the power to devalue its currency in order to reduce the price of its exports. Therefore it is more important for the government of the country to follow policies that keep inflation under control.

**Model sentence:** Membership of a monetary union increases the level of cross-border investments, reduces transaction costs, increases price transparency, and eliminates the disadvantages of exchange rate fluctuations.

The disadvantages of monetary union are explained below.

### Explain the consequences of a single interest rate

Member countries belonging to the Euro-zone are in different stages of the **economic cycle**. A country that is experiencing high rates of inflation will need to set a relatively high interest rate to reduce inflationary pressures. A country in a **recession** will need to set a relatively low interest rate in order to increase **aggregate demand** and increase the **rate of economic growth**. The interest rate for the euro is set by the European Central Bank but the rate it sets might not be the right one for all the countries in the union. This means that recessions will be deeper and longer if the interest rate is high and inflation may not be brought under control if the interest rate is low. The central bank is not able to set the appropriate interest rate for all countries in the monetary union.

**Model sentence:** A single interest rate covering all countries in a monetary union means that individual countries lose the power to change monetary policy to suit their position in the business cycle.

### Explain the consequences of losing control over the exchange rate

A country that wants to increase the competitiveness of its exports can devalue its currency in order to lower the price of its exports, thereby increasing the quantity of exports demanded. Countries in a monetary union are not able to do this so exporting industries may not survive, leading to a fall in **GDP** and an increase in unemployment.

### Explain the consequences of losing control over fiscal policy

If fiscal policy is controlled centrally, countries may lose the power to reduce or increase their taxes in order to change aggregate demand. Governments also lose the power to be able to borrow in order to increase aggregate demand. Countries lose the power to introduce **contractionary fiscal policy** or **expansionary fiscal policy** to achieve their **macroeconomic objectives**.

### Explain the costs of monetary conversion

There are costs of converting from one currency to another that are paid by the taxpayer and businesses. The old currency must be replaced with the new and distributed throughout the economy. All machines that take notes and coins have to be replaced or adjusted to accept the new currency. Businesses must re-price all goods and, for example, print new catalogues.

### Explain the concept of trade creation (HL)

See pages 196–201 for a detailed explanation of how the theory of **comparative advantage** demonstrates that the removal of barriers to trade increases world output.

Trade creation occurs in a trading bloc when agreements are reached on reducing **trade barriers** that lead to an increase in production and consumption. When barriers to trade, such as **tariffs** and **quotas**, are reduced or removed the production of certain goods and services switch away from relatively high cost producers in one country to relatively low cost producers in another country. Buyers in countries in a common market now buy goods from firms producing at lower average total cost and selling at a lower price.

For example, a country outside of the European Union (EU) has placed a tariff on imported cars from the EU in order to protect the domestic producers of cars. The EU has placed a common tariff on cars entering the EU. The common tariff does not apply to cars produced and sold within the EU. The country now joins the EU, therefore the tariff on imported cars from member countries is removed. Buyers of cars in the country now switch expenditure away from the higher priced domestically produced cars to the lower priced imported cars. Expenditure moves away from high cost producers to low cost producers. Consumers in the country benefit because they are able to buy cars at a lower price from more efficient producers. **Purchasing power** of income rises and consumers are able to buy more with their income, thereby increasing demand for other goods.

Firms in a country also benefit when the country joins a common market. They are able to buy **raw materials** from a supplier producing at low average total cost and selling at a low price, thereby reducing their costs of production. This might lead to an increase in supply and a fall in price of the goods they are producing.

Free trade agreements shift the production of some goods and services away from a high cost country to a low cost country that has the comparative advantage in the production of the good or service. Efficient firms increase their **market share** and increase output. Increases in the scale of production increase the cost advantages gained from **economies of scale** leading to lower average total costs.

In theory, when all firms in the common market specialize in the production of goods that they are able to produce most efficiently, the total output from a given quantity and quality of **factors of production** increases. Factors are allocated more efficiently leading to welfare gains.

### Explain the concept of trade diversion (HL)

Trade diversion occurs when expenditure in a country switches away from low cost producers to high cost producers after the country joins a common market. The common market has in place common tariffs on certain imported goods coming into the common market from low cost countries outside the common market. Before the country joined the common market there were no tariffs placed on the goods coming from

## Subject vocabulary

**GDP** gross domestic product is the monetary value of all the finished goods and services produced within a country in a given period of time, usually measured over a year

**contractionary fiscal policy** policy involving the reduction of government spending and/or the increase of taxation

**expansionary fiscal policy** policy involving the increase of government spending and/or the reduction of taxation

**macroeconomic objectives** the main aims of government macroeconomic policy, such as low and stable inflation, low levels of unemployment and sustainable economic growth

**comparative advantage** when a country, firm, or individual is able to produce a particular good or service at a lower opportunity cost than other countries, firms or individuals

**trade barriers** restrictions put in place by government on international trade in order to protect domestic jobs and industries. Examples include subsidies and tariffs.

**tariffs** a tax placed on imported goods and services

**quotas** a physical limit placed on the number of goods that can be traded or produced

**purchasing power** a measure of how many goods and services a given amount of money can buy

**raw materials** the basic material from which a good is made

**market share** the proportion of the market supply of a good or service that is controlled by a firm

**economies of scale** the fall in average cost in the long run brought about by an increase in the size of a firm's operation

**factors of production** the inputs into the production process (land, labour, capital and entrepreneurship)

## Subject vocabulary

### **misallocation of resources**

occurs when the allocation of resources leads to welfare loss and therefore a reallocation of resources could increase society's welfare

**welfare** the benefit gained from consuming and producing goods

**consumer surplus** the difference between the price a consumer is willing and able to pay and the price the consumer actually pays

**real income** income after taking into account the effects of inflation on purchasing power

the low cost producers outside. Buyers enjoyed the advantages of paying a low price. After the country has joined the common market the common tariff placed on the goods increases the prices of the imported goods. It is now cheaper to buy the goods from high cost producers in countries that are members of the common market. Therefore expenditure in the country switches away from low cost countries to high cost countries.

Buyers now pay a higher price for certain goods which reduces the purchasing power of their income.

More output is produced by less efficient firms and less is produced by the more efficient firms leading to a **misallocation of resources** and a reduction in society's **welfare**. However, the benefits gained from joining the common market may outweigh the disadvantages of not being a member.

**Model sentence:** Trade diversion occurs when a country joins a common market with common tariffs thereby shifting demand for goods away from low cost countries outside the common market to high cost countries within the common market.

## Explain that economic integration allows member countries to gain from economies of scale (HL)

The size of a common market is greater than the size of a country's domestic market. As more countries join a common market the size of the market grows. The population of the EU, consisting of 28 member countries, is estimated to be 508 million. This is much higher than the most heavily populated member country, Germany, which has a population of about 81 million.

A firm producing within the EU, with no barriers to trade, that produces a good that is consumed by a large proportion of people living in the EU has the opportunity to increase sales by a very large amount. If a firm can take advantage of the size of the market it will be able to gain greater economies of scale. It is not easy for a firm to gain market share because tastes and preferences vary a lot across the 28 countries of the EU. There are many goods, however, produced by firms that are close substitutes, for example, food products and manufactured goods, such as office furniture and stationery and household durables such as washing machines, that can be sold to buyers throughout the EU. These firms, if they are able to produce at low average cost, may grow in size and be able to enjoy the economies of scale available from production on a large scale.

As the average cost of production on many goods falls throughout the common market it is possible that prices will fall leading to an increase in **consumer surplus** and **real income**.

### Test your understanding of this unit by answering the following questions

- Distinguish between a customs union and a monetary union.
- Discuss the possible advantages and disadvantages of monetary union.
- Using the concepts of trade creation and trade diversion, explain the possible advantages for and disadvantages against a country joining a monetary union.